

## M INTELLIGENCE

# TAX TREATMENT OF SUPPLEMENTAL INDIVIDUAL DISABILITY INSURANCE PLANS

This document will provide an overview of the tax treatment of employer-sponsored supplemental IDI options, including salary continuation plans and executive bonus plans.

Disability insurance plans for the purpose of income protection can be designed in a multitude of ways to achieve the objectives of both the individual employee and the employer. Coverage is often sponsored by employers in the form of group short-term disability (STD) and/or long-term disability (LTD) insurance plans for all benefit-eligible employees at an affordable premium. However, due to benefit levels, policy structure, and compensation of the insured, these plans are not always designed to adequately protect the earnings of key employees with high incomes.

To address these concerns, supplemental individual disability insurance (IDI) is often made available to a select group of individuals who are adversely impacted, albeit unintentionally, by the shortfalls or gaps of the group disability plan. As examples, an organization may offer supplemental IDI to:

- Augment the group plan for a large population of key employees to enhance their benefits package and more adequately protect their income.
- Enable the partners of a small law firm to better protect their total compensation against a long-term disability that could severely restrict the ability to fund their retirement plans.

Whatever the reason and concern of the client, obtaining supplemental IDI coverage through an employer is considered an advantageous and cost-effective way to purchase the coverage. The design of the plan, however, determines whether the premiums or benefits are taxed, as well as the tax liability of the employee versus the employer.

## THE BASICS: TAX TREATMENT OF SUPPLEMENTAL IDI

The primary rule used to determine whether a benefit is taxable or non-taxable focuses on whether the IRS permits the premium to be deducted as an expense by the business or considers it a non-deductible personal expense by the employee. *If the premium is deductible, the benefit received is generally taxable.*

The insurance premiums for the supplemental IDI coverage can be paid by the employer, by the employee, or by a combination of both, and the tax treatment of the premium payments, as well as the benefits received, will be different in each scenario.

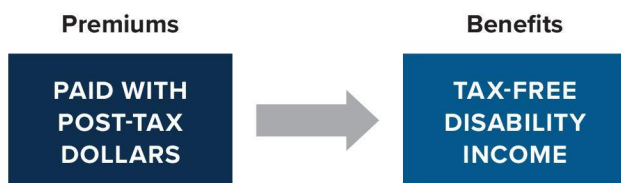
When coverage is purchased through an employer, the taxability of disability benefits received is dependent upon who is responsible for paying the premium and whether the premiums were paid post-tax or pre-tax in the year in which the benefits are paid.

## POST-TAX FUNDING METHODS

- Premiums are paid by the key employee through the employer's payroll deduction after FICA and income tax withholdings have been applied to gross pay; or
- Premiums are paid by the employer and reported as additional salary or bonus compensation in the key employee's W-2 earnings rather than deducted from their paycheck.

### Result: Taxes are incurred now

Premiums for the policies are being taxed as ordinary income and therefore any benefits received will be tax-free under either administrative method. The tax liability will be increased for the key employee, but benefits are received income tax-free in the event of a claim.



## PRE-TAX FUNDING METHODS

- Premiums are paid by the employer to the insurance company for each key employee's policy and the premiums are not included in the employee's W-2 earnings statement.
- Premiums are paid by the employee through a cafeteria plan with no FICA or income taxes withheld.

### Result: Taxes are incurred later

Premiums for the policies are not being taxed, and therefore any benefits received in the event of a claim will be taxable as income.



Regardless of the premium payer, taxes will need to be paid — either on the insurance premium (taxes incurred now) or on the disability benefits received (taxes incurred later).

## THE DETAILS: TAXATION OF DISABILITY PLANS FOR KEY EMPLOYEES

Employers may choose to offer disability coverage only to key employees of the company. They are not required to offer the same or similar coverage to other employees, and there are no legal or tax penalties for doing so.

Two common approaches employers use to provide supplemental disability benefits to select groups of individuals are the salary continuation plan and the executive bonus plan. Each of these plans has different funding and tax implications:

### SALARY CONTINUATION PLANS

A **salary continuation plan** (also known as a wage continuation or qualified sick pay plan) is a formal written plan that addresses if and how a disabled employee can continue to receive compensation from the employer during a period of disability.

Employers may establish a reserve to pay disability benefits to key employees as claims arise or they may choose to pay benefits out of current earnings or profits. Either way, the employer's outlay can be expensive, so an attractive alternative is to fund that liability with individual disability policies.

Funding the salary continuation plan with individual disability policies transfers the risk of a potentially long-term salary payment to a disabled employee from the employer to the insurance company. Employer plan contributions (i.e., premiums for the IDI policies) are deductible by the employer as reasonable compensation under IRC section 162 and are not included in employee income under IRC section 106.

Under IRC section 105, policy benefits paid to the insured employee at claim time will be reported as income to the employee and taxed. Below is a summary of the tax impact depending on whether the employer or employee owns the policy under a salary continuation arrangement:

- **Employee-Owned:** The employer's plan contributions or premium payments are deductible by the employer as reasonable compensation. Premiums are not included in the key employee's income, but benefits are taxable to the employee/insured when received.



- **Employer-Owned:** If the employer chooses to purchase and own the policy insuring a key employee and uses the policy proceeds to cover the cost of the employer-paid benefits to the employee, the premium payments are not tax-deductible by the employer. Premiums are not included in the key employee's income and benefits are taxable to the employee/insured when received.
- **Co-Owned:** If the employer pays a portion of the premium and the employee pays a portion of the premium, the portion of the benefits attributable to the employer's premiums is taxable to the employee, and the portion paid by the employee with after-tax money is free of income tax.

It is important to understand who qualifies for this type of plan: Under Treasury Regulation section 1.105-4(a)(2) (i), a salary continuation plan is defined as an accident or health plan. An accident or health plan is further defined in section 1.105-5(a) as “an arrangement for the payment of amounts to employees in the event of personal injuries or sickness. A plan may cover one or more employees, and there may be different plans for different employees or classes of employees.”<sup>1</sup>

By indicating “employees,” this would mean that a plan can be established to provide benefits for all employees, including owners of C Corporations, or to

a select group of employees. However, owners of S corporations or sole-proprietorships, partnerships, and limited liability companies (LLCs) are not considered employees and, therefore, are not generally eligible for benefits under a salary continuation plan.

## EXECUTIVE BONUS PLANS

A common strategy for employers to provide supplemental IDI coverage to key employees — and avoid income taxation on the benefits received by their employees — is to create an executive bonus plan.

With an **executive bonus plan**, or **Section 162 bonus plan**, an employer purchases an IDI policy on behalf of a key employee and pays the premiums, either through a salary increase or a bonus payment. The additional income to the employee is tax-deductible by the employer as a “reasonable business expense” under IRC section 162.

As for the employee, the salary increase or bonus payment must be reported as income to the executive under IRC section 61. The taxes paid on the premium will likely be far less than what the taxes might end up being on the benefits received in the event a claim occurs. Since the executive pays the taxes on that premium, the benefits received at claim are excluded from income (under section 104) and are free from any income and employment tax.

Alternatively, an executive bonus plan may provide a “gross up” on the bonus in an amount equal to the estimated tax on the bonus so that the executive's out-of-pocket cost is essentially zero. The employer is still able to deduct the bonus and the “gross up” paid as a normal business expense under IRC section 162, assuming it is a reasonable amount when compared to other key executives. The “reasonableness” requirement under the IRC section 162 is usually not heavily scrutinized.

### Summary: Key Tax Advantages of a Salary Continuation Plan Using Individual Disability Insurance Policies

- Premiums are tax-deductible by the business, generally as an ordinary and necessary business expense.
- Premium payments made by the employer are not taxable income to the insured employee.
- Benefit payments to the employee are taxable as income but not subject to Social Security taxes after the first six months of disability.

<sup>1</sup> <https://www.govinfo.gov/content/pkg/CFR-2021-title26-vol2/pdf/CFR-2021-title26-vol2-sec1-105-5.pdf>

## SECTION 162 EXECUTIVE BONUS EXAMPLE

	Individually Purchased	Employer-Sponsored Voluntary (Payroll Deduction)	Employer-Sponsored Mandatory (Employer-Paid)	Section 162 (Employer-Paid; Imputed Premium)
Monthly Pre-Tax Individual Disability Benefit	\$10,000	\$10,000	\$10,000	\$10,000
Tax (@40% <sup>†</sup> ) to Employee	\$0	\$0	\$4,000	\$0
Monthly After-Tax Benefit	\$10,000	\$10,000	\$6,000	\$10,000
Gross Annual Premium	\$5,755	\$4,604 <sup>+</sup>	\$3,165 <sup>*</sup>	\$3,165 <sup>*</sup>
Minus Deduction for employer (@26% <sup>†</sup> )	0	0	823	823
Net Annual Premium	\$5,755	\$4,604	\$2,342	\$2,342
Cost Per \$100 Benefit After-Tax Benefit	\$57.55	\$46.04	\$39.03	\$23.42
Imputed As Income by Employer	NA	NA	NA	\$3,165
Net Cost/Tax to Employee	\$5,755	\$4,604	\$0	\$1,266
Benefit Received	Tax-free	Tax-free	Taxable	Tax-free

\* 45% employer-paid premium discount applied to policy

+ 20% employer-sponsored premium discount applied to policy

† Sample corporate and individual federal/state tax rates

Premiums illustrated above assume coverage for a 45-year-old executive employee and benefit provisions, which include: 90-day elimination period, age 67 benefit period, return to work benefits, and full coverage for mental/nervous/drug/alcohol disabilities.

### Chart Summary

- A Section 162 executive disability bonus arrangement allows coverage to be obtained at 59% less net premium than individually-purchased coverage.
- Imputed premium can be “single-bonus (only premium imputed)” or “double-bonus (premium plus estimated tax on premium)” in design.
- Compared to employer-paid coverage with no bonus, employees receive \$10,000 of monthly benefit versus \$6,000 without a bonus arrangement.

One advantage of an executive bonus plan versus a salary continuation plan is that any business owner — including those of LLCs, sole proprietorships, partnerships, and S corps — can utilize an executive bonus arrangement under IRC section 162. A salary continuation plan, however, can only be utilized for “employees” of organizations, as noted above. (For more details, see Appendix: Premium Deductibility and Benefit Taxation by Business Type.)

Another difference between a salary continuation plan and an executive bonus plan is that under an executive bonus plan, the executive receives the cash that could be used for any purpose but is used by the business to make disability insurance policy premium payments

to the insurance carrier. With a salary continuation plan, the employer premium contributions to the plan must be devoted solely to insurance premiums or to fund self-insured benefits that are promised.

### Summary: Key Tax Advantages of an Executive Bonus Plan

- Businesses can provide select employees with valuable coverage to reward loyalty and improve retention.
- Most business entities can implement this type of plan.
- Bonuses in the amount of the premium payments made by the employer are tax-deductible by the business.
- Bonus payments are taxable income to the insured employees but can be “grossed up” to account for the extra cost of the taxes on the payment, resulting in no cost to the employee.
- Since the key employee pays taxes on the premium included in their income, benefits received at claim-time are free from income and employment tax.

## Voluntary Plans

When a voluntary individual disability plan is sponsored by an employer, the employee pays 100% of the premium with after-tax dollars and the disability benefit payments at claim will be income tax-free.

There are situations in which an employee-paid plan can be funded on a pre-tax basis through a Section 125 cafeteria plan. However, all benefits paid will be fully taxable and, therefore, rarely implemented in this fashion. Health insurance premiums are well-suited to section 125 plans, but disability insurance premiums are not, due to the tax consequences at claim time (i.e., taxable benefits).

## CONCLUSION

Supplemental individual disability insurance plans offer additional income protection and can be used to enhance an organization's benefit package to assist in recruiting and retaining key employees, reduce risk and exposure to plan volatility, and promote goodwill and communication with employees. It further provides employees with access to comprehensive coverage on a guaranteed basis that they may not be able to obtain elsewhere. Depending on the plan design, benefits or premiums can be taxed. A disability insurance professional can help employers understand these tax implications and select the most appropriate plan.

*M Financial Group is a leading life and disability insurance distribution, service, and product organization serving high net worth individuals, executives, and employers. M Financial Member Firms have provided executive disability plans to employers for over 35 years. We help companies pick the best supplemental IDI plans based on their unique goals, objectives, and tax strategy.*



## APPENDIX: PREMIUM DEDUCTIBILITY AND BENEFIT TAXATION BY BUSINESS TYPE

The following chart highlights the tax scenarios of supplemental IDI for various types of businesses.

Insured	Insurable Income	Treatment of Premium	Benefit Taxability
<b>SOLE PROPRIETORSHIP</b>			
<b>Owner</b>	Net profit	<ul style="list-style-type: none"> <li>Not deductible by business – IRC 105(g) &amp; 265</li> </ul>	<ul style="list-style-type: none"> <li>Non-taxable – IRC 104(a)(3)</li> </ul>
<b>PARTNERSHIP</b>			
<b>Employee</b>	Salary, bonus, commissions	<ul style="list-style-type: none"> <li>May be deducted by business – IRC 162(a)</li> <li>Excluded from employee's Income – IRC 106(a)</li> </ul>	<ul style="list-style-type: none"> <li>Taxable if premiums paid &amp; deducted by business – IRC 105(a)</li> <li>Non-taxable if paid by employee – IRC 104(a)(3)</li> </ul>
<b>Partner</b>	Allocated share of net profit (loss) + guaranteed payments	<ul style="list-style-type: none"> <li>Not deductible by business – IRC 265</li> <li>May be deducted as "guaranteed payments" which are included in partner's taxable income – IRC 707© &amp; 162(a)</li> </ul>	<ul style="list-style-type: none"> <li>Non-taxable – IRC 104(a)(3)</li> </ul>

Note: "Partner" groups may be corporations or LLCs/LLPs. The business entity is likely S corporation, LLC, or LLP if "partners" receive both a K-1 and W-2.

<b>LIMITED LIABILITY PARTNERSHIP (LLP) OR LIMITED LIABILITY COMPANY (LLC)</b>			
<b>Employee</b>	Salary, bonus, commissions	<ul style="list-style-type: none"> <li>May be deducted by business – IRC 162(a)</li> <li>Excluded from employee's Income – IRC 106(a)</li> </ul>	<ul style="list-style-type: none"> <li>Taxable if premiums paid &amp; deducted by business – IRC 105(a)</li> <li>Non-taxable if paid by employee – IRC 104(a)(3)</li> </ul>
<b>Member</b>	Allocated share of net profit (loss) + salary	<ul style="list-style-type: none"> <li>Not deductible by business – IRC 265</li> <li>May be included in W-2 as Section 162 "bonus" if entity taxed as corporation</li> </ul>	<ul style="list-style-type: none"> <li>Non-taxable – IRC 104(a)(3)</li> </ul>

Note: See notes under "Partnership," above. Sole proprietors that want the legal protection afforded LLCs may form as a "Single Member LLC" (SMLLC).

C-CORPORATION			
Employee	<ul style="list-style-type: none"><li>• Salary, bonus, commissions</li><li>• Deferred compensation</li><li>• Equity-based compensation</li></ul>	<ul style="list-style-type: none"><li>• May be deducted by business – IRC 162(a)</li><li>• Excluded from employee’s income – IRC 106(a)</li></ul>	<ul style="list-style-type: none"><li>• Taxable if premiums paid &amp; deducted by business – IRC 105(a)</li><li>• Non-taxable if paid by employee – IRC 104(a)(3)</li></ul>
Shareholder Employee	Same as employee plus: <ul style="list-style-type: none"><li>• Share of net profit (loss)</li><li>• Pension contribution</li></ul>		
S-CORPORATION			
Non-Shareholder Employee	Salary, bonus, commissions	<ul style="list-style-type: none"><li>• May be deducted by business – IRC 162(a)</li><li>• Excluded from employee’s income – IRC 106(a)</li></ul>	<ul style="list-style-type: none"><li>• Taxable if premiums paid &amp; deducted by business – IRC 105(a)</li><li>• Non-taxable if paid by employee – IRC 104(a)(3)</li></ul>
Shareholder Employee (2% or less ownership)	<ul style="list-style-type: none"><li>• Salary, bonus, commissions</li><li>• Share of net profit (loss)</li></ul>	<ul style="list-style-type: none"><li>• May be deducted by business – IRC 162(a)</li><li>• Excluded from employee’s Income – IRC 106(a)</li></ul>	<ul style="list-style-type: none"><li>• Taxable if premiums paid &amp; deducted by business – IRC 105(a)</li><li>• Non-taxable if paid by employee – IRC 104(a)(3)</li></ul>
Shareholder Employee (>2% ownership)	<ul style="list-style-type: none"><li>• Pension contribution</li><li>• Deferred compensation</li><li>• Equity-based compensation</li></ul>	<ul style="list-style-type: none"><li>• Premiums included in W-2 wages for income tax purposes (not subject to Social Security or Medicare), therefore deducted as compensation by the business (IRS Notice 2008-1)</li></ul>	<ul style="list-style-type: none"><li>• Non-taxable – Revenue Rule 56-326; Revenue Rule 58-90</li></ul>

Note: IRS Notice 2008-1 DI premium must be included in W-2 wages.

Source: Unum "Disability Income Taxation Guidelines"

Summary of Internal Revenue Code Sections:

- Deductibility of Premium: IRC Sections 152(a), 105(g) & 265
- Premium Excluded from Employee's Income: IRC Section 106(a)
- Taxability of DI (LTD and/or IDI) Benefits: IRC Section 104(a)(3) & 105(a)

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